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DermaCare: Zapping Zits Directly

It was a rainy Saturday morning in late November 2005, and Peter Scocimara pulled on his Croc shoes to take his rambunctious golden retriever Jasper for a walk. Walking the dog would give Scocimara some much-needed time to clear his head and prepare for a Monday-morning meeting with the cofounders of his company, DermaCare, Inc. Headquartered in Livermore, California, DermaCare was a start-up venture that planned to market its ThermaClear acne-treatment device directly to consumers using direct response television (DRTV).

Scocimara was DermaCare's CEO, and he and his cofounders, Luiz Da Silva and George Choi, were excited about the company's prospects. Early clinical trials showed that the ThermaClear acne device made pimples disappear twice as quickly as those left untreated. With those results in hand, Scocimara and Choi approached angel investors, including Silicon Valley-based Band of Angels, to raise a Series A round. Just before Thanksgiving, the Band of Angels sent Scocimara a term sheet that offered the company \$1.5 million, assuming a \$4.5 million postfinancing valuation. Shortly thereafter, the CEO unexpectedly received a competing term sheet from Foundation Capital, a venture capital (VC) firm where his good friend and former business school classmate Charles Moldow was a partner. The VC's term sheet offered the company \$4.0 million in funding, assuming a \$7.65 million postfinancing valuation. Moldow structured the proposed deal so that DermaCare would receive \$1.0 million up front and the remainder after the Food and Drug Administration (FDA) gave DermaCare clearance to market its acne device.

Scocimara was in a quandary. The angel and VC offers were markedly different, and Scocimara was still deciding which one to recommend to Da Silva and Choi. On first glance, the angel term sheet seemed more attractive. It offered the level of funding the company had asked for with less dilution. However, the CEO wondered whether the \$1.5 million was really adequate to get the company past the next hurdle. The clinical trials were taking longer than expected, which would delay FDA approval; and the manufacturing costs for the device were coming in higher than anticipated.

One thing Scocimara knew for certain: He was eager to close the financing round. The company was running short on cash and had recently increased its monthly burn rate after hiring its first employee—an engineer. Furthermore, DermaCare was at best several months from launching its ThermaClear device, and a competitive product—the Zeno Zit Zapper—had already beaten them to market. Scocimara was also ready to get a paycheck; he had spent the last year working on the DermaCare venture without pay. Jasper barked at the front door, clearly anxious to get outside. As Scocimara thought about the route they would take around the tree-lined neighborhood, he decided to vary their usual walk to avoid his friend Moldow's house a block away.

Professor Richard G. Hamermesh and Research Associate Lauren Barley prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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DermaCare Cofounders

Luiz Da Silva

Da Silva, a native of Canada, received a PhD in physics from the University of British Columbia in 1988. Soon thereafter, Da Silva moved to California for the opportunity to work with “the world’s most powerful laser” at the Lawrence Livermore National Laboratory (LLNL). By 1997, Da Silva was ready for a new challenge. He and his boss then started the medical technology program at LLNL, and Da Silva explained his role as its associate program director:

Our mission was to take technology and patents developed at the lab and transfer them to the medical industry. My first experience was to pitch some technology the lab had for treating strokes. We visited some VCs, and eventually a group of VCs found a CEO and formed a start-up to license and commercialize our technology. I was the “science guy” responsible for the patents and technology, and my involvement with the company lasted about a year until the start-up grew up and took over the opportunity.

Da Silva continued to grow the medical technology program within LLNL, earning a Federal Laboratory Consortium award for “excellence in technology transfer” in 1998. But Da Silva left the LLNL in 2001. As he recalled, “Increasing security concerns at the lab arose, which made growth more difficult. Bureaucracy began to slow everything down until I was doing very little real science and very little real business.” Da Silva and two colleagues started a “technology incubator” in 2001 to form companies around ideas the three patented. Two of their companies, DermaHealth Systems (a plastic surgery device company) and ImagiNail Corporation (a consumer products company), were already operational and had received funding by 2002.

George Choi

Choi met Da Silva in late 2001. Choi had graduated from University of California, Berkeley, with a BS in electrical engineering and computer science. After receiving a law degree from the University of California, Los Angeles, Choi joined the law firm Wilson, Sonsini, Goodrich & Rosati in 1990 and worked primarily with VC-backed medical device start-up companies in the Bay Area. In 1995, Choi “hopped the fence,” becoming a venture capitalist with MedVenture Associates, a firm founded in 1986 to fund seed and early-stage investments in medical technology. It was at MedVentures that Choi met Da Silva, who pitched Choi several companies Da Silva was thinking of incubating and running. Choi described their first meeting: “Luiz came to me with some deals, which I turned down. But I must have done it in a reasonable manner, because we kept up a relationship, talking at times about various medical technologies.”

One of the ideas Choi and Da Silva discussed was using lasers for acne applications. There were many forms of acne, ranging from blackheads, whiteheads, and pimples to severe forms such as cystic or modular acne. Da Silva, whose scientific background was with lasers, had seen dermatologists use laser technologies in the treatment of mild to moderate inflammatory acne, most commonly referred to as “pimples,” “breakouts,” “blemishes,” or “zits.” Choi summarized the science behind the laser treatments:

Lasers treat acne in two possible ways. At certain wavelengths—or colors—lasers go into the skin tissue and generate oxygen radicals, which kill the bacteria and reduce inflammation. At other wavelengths, lasers are basically heat sources that reduce sebum [an oily substance produced by certain skin glands] production by killing and reducing the number of sebaceous glands. This decreases the likelihood that excess sebum clogs pores, which can lead to acne.

However, a laser was an expensive solution for treating acne. Da Silva and Choi believed they could replace a laser, which cost between \$20,000 and \$50,000, with a \$5 to \$10 heater using a thin-film resistor (a thin piece of metal that converts electrical current into heat). As Choi explained, “We believed our device could offer similar therapeutic benefits to a laser, but at a much lower cost.”

Peter “Scotch” Scocimara

Born in Switzerland to a Swiss father and Greek mother, Scocimara earned a bachelor’s degree from Brown University and an MBA from Harvard University in 1993. By 2002, Scocimara joined WebEx Communications (a software company that provided on-demand collaboration applications such as web conferencing), where he was vice president of customer success. A couple of years later, Scocimara left WebEx to become vice president of sales and marketing for LiveOps Inc. Scocimara recalled his experience there:

LiveOps was a “virtual call center,” and I ran revenue, sales and marketing, product management, and account management. I learned the direct-response television business there. I got to know products like Proactiv [a three-step skin-care system for clearing and preventing acne], the George Foreman Grill, and Jack LaLanne Juicer. We tend to think of direct-response businesses—with their infomercials—as real “schlock” businesses. But I watched these companies come up with product ideas, put them on TV, and the phones were ringing off the hook. I learned that when you matched the right products with the right audiences, they were great businesses.

A few months into his job at LiveOps, Scocimara had Choi over to his home. The two had become good friends several years earlier while organizing a school camping trip for their same-aged daughters. Scocimara described the conversation they had in October 2004:

George said he wanted to start distributing a printer that could print any JPEG image you wanted on a fingernail—like a flag or a picture of your kids or dog—that Luiz developed for his start-up company ImagiNail. He wanted to know if DRTV would work for it. I told George it was never going to fly. If he looked at the number of people who owned computers, who also watched TV infomercials, and who bought products on TV, there wasn’t a big enough market. Plus, the cost of sales was going to be \$45 at best, which meant they’d have to sell it for \$250 to make any money after marketing and fulfillment costs.

A little later into the evening, the two discussed another business opportunity. Scocimara continued:

Then George said, “What if I had a product with a much lower cost of goods—that was under \$10 to manufacture—that could help clear pimples faster?” I replied, “I’ll write you a check for \$100,000 right now if it works.” George couldn’t understand why I would do that. Coming from his world of VC-backed medical device start-ups, George assumed the acne device would be sold to dermatologists using a specialized sales force. There are 7,500 dermatologists; the product would sell for \$400; each patient would buy a \$30 replaceable tip; at the end of the day, it would be a \$50 million business. I responded, “Why waste your time with 7,500 dermatologists? There are millions of people with acne. And, at a \$10 cost of goods, I could sell it for \$49.95 on TV, all day long. Sell a million at \$50 a pop, and that starts to look more interesting. Then make it two million, then three million. Add some topical acne treatments to the product line and turn a \$50 sale into \$150.”

Company Background

By November 2004, Da Silva and Choi were ready to form a company around their ThermaClear acne-treatment device. Choi sought Scocimara's advice as they began their CEO search. Choi recalled, "I had largely forgotten the discussion Scotch and I had had the previous month. I thought Scotch might know someone he could recommend for the CEO position. I was surprised when he said he wanted the job."

As Scocimara took Choi down to Los Angeles to meet with "gurus" in the DRTV industry, Choi warmed to the idea of having Scocimara as the company's CEO. Choi recalled, "The head guru didn't throw us out, which I thought was a good sign. In fact, he gave us a lowball offer for the company. I could have been offended. Instead, I thought, 'Wow, there must be something there.' And you know what? Scotch could make a good CEO." Da Silva quickly agreed, adding, "All Scotch's previous employers had glowing comments about him. He also really believed in the product—he tested the device on himself, and he was willing to put his own money in down the road and not take a salary until we could raise money." Scocimara remained at LiveOps over the next five months but began working on a business plan with Choi.

In late November, Choi and Da Silva filed the articles of incorporation, calling their new company DermaCare. The two contributed \$10,000 each for early product development and intellectual property work. They wrote and filed provisional patents on their idea by the end of the year.

The ThermaClear Acne-Treatment Device

In January 2005, Da Silva began early concept work on the first prototype of the acne device. He farmed the project out to a group of Russian nuclear scientists he had met while working at LLNL. The Russian scientists chose equity in the company instead of getting paid for their services. Scocimara commented:

These guys are gods in the physics world. There are material scientists, electrical engineers—all under one roof. Luiz told them what we wanted, and what it had to do. In two weeks, we had the first concept. Luiz burned his face, but that was part of the development cycle. We tested a whole bunch of different capacitance capabilities, and we'd sit there and say, "How's that feel? Aaaagh!"

By February 2005, the first prototype was ready for testing. The device, which was AC powered, used a very short blast of high heat on the surface of the skin to reduce the inflammation and redness caused by acne pimples. It was a big box with knobs that controlled the four temperature settings, ranging from 60 degrees to 120 degrees Celsius. Two wires ran from the box to a thin-film resistor that was applied directly to the skin. Da Silva called it "the Frankenstein version of the device." Choi added, "I had friends who told me, 'Don't get near me with that thing.'" Nonetheless, the three found some willing family members (including Choi's wife and daughter), friends, and colleagues who tried the device, accumulating anecdotal evidence that their invention worked.

Business Model

In spring 2005, Scocimara fine-tuned DermaCare's business model. His research indicated that roughly 45 million people suffered from acne in the U.S. alone and spent approximately \$2 billion on over-the-counter (OTC) treatments, many of which were ineffective. OTC treatments could be classified as either "preventative" or "spot." Preventative treatments were designed to clean skin to prevent pore blockages (e.g., daily cleansers or exfoliants) or deliver medication (e.g., benzoyl peroxide or salicylic acid) to the surface of the skin to help prevent new acne breakouts. Topical spot

treatments were used to clear pimples faster once they had occurred. Scocimara commented, "There was no clear evidence that any of these spot treatments worked. They were basically marketed as 'hope in a bottle.'"

DermaCare planned to sell the ThermaClear product line, which included the acne device (spot) and a line of topical acne treatments (preventative), directly to consumers using infomercials that targeted women and mothers of teens with acne. Scocimara explained the company's rationale behind using DRTV to distribute its products:

We believed the potential market was much larger by selling our product line directly to end users rather than using a specialized sales force to call on the 7,500 dermatologists who would then sell it to their patients. We debated using the retail channels for distribution, but a typical brand-management company spends \$50 to \$100 million to launch a consumer product at retail. It gives 40% to 60% of the profit away immediately to the retailer who is "selling" it. And the company still needs to spend money on building awareness of its product. I thought we could sell ThermaClear directly to the consumer using DRTV. Our marketing and fulfillment costs would be high, but they wouldn't equal the amount we would give away to the retailer under the first scenario.

According to Scocimara, there were several keys to success in the DRTV environment. He described what these were and why ThermaClear was well positioned for success:

First, there has to be a large population of people who want or need the product, which means it typically has to appeal to one of three core needs: "I want to feel better about myself—or look better"; "I want others to like me more"; or "I want to save time and be more efficient." Second, the product has to be demonstrable with compelling testimonials. And, third, it has to sell for at least five times its cost to manufacture.

Our device appealed to the most important core need: "I want to feel/look better." That's why diets, exercise programs, and beauty products work so well on DRTV. One of the nice things about the acne market is that there is no cure. Most of the products are over-the-counter, and as everyone knows, they don't particularly work. Acne makes people very self-conscious, and as in everything cosmetic, "hope springs eternal." So our product potentially appealed to a large, dissatisfied population that was distrustful, but at the same time very willing to try anything new that might work. And with what we thought was a \$5 to \$10 cost of goods, it hit a great price point—\$49.95.

Assuming ThermaClear was successful using DRTV as Scocimara predicted, the product line would self-fund its growth. Scocimara explained:

DRTV is an extremely capital-efficient model. With a \$100 retail price, you pocket roughly \$15. Here's how you get there. You spend \$50,000 on DRTV the first two weeks to test your product. If it is testing well, you've generated at least \$50,000 in revenue. You can then expect at least a two-to-one ratio on your media [net revenue dollars divided by total media dollars]. This means that when you launch the product, you spend \$50,000 in media but now generate \$100,000 in sales. You subtract your 20% cost of goods sold—a five-to-one ratio. And then you add the cost of answering phones and/or web sales, which is almost zero. Next, subtract the fulfillment costs, which are roughly \$10 a product, including shipping. You then take that \$100,000 you earned at rollout and spend it on media. It turns into \$200,000 in revenue—as long as you are getting at least a two-to-one ratio on your media. Your \$200,000 becomes \$400,000. You get to a point within a few months where you're at the equivalent of a \$5 to \$6 million annual media spend, and the dollars are rolling in.

After the brand built awareness, Scocimara planned to expand distribution of the ThermaClear product line by also selling it through the mass-market retail channels. To keep headcount down, the company would outsource production of the device and topicals, as well as fulfillment and customer service.

Demonstration and Clinical Trials

In April 2005, Scocimara left LiveOps to become DermaCare's CEO full-time. Choi drafted a basic shareholder agreement in which Da Silva and Choi agreed to license the product technology royalty-free to the company. Choi contributed an additional \$100,000, Scocimara \$103,750, and several other investors \$51,875. (See **Exhibit 1** for initial capitalization.) The founders planned to use the capital to continue prototype development and to fund an initial human trial to demonstrate that the ThermaClear device worked. As Da Silva explained, "After we reached these milestones, we planned to go to investors with the working prototype and our business plan, which we believed would justify a \$2 to \$3 million pre-money valuation."

The second prototype was ready for testing by the end of April, and like its predecessor, it delivered a short thermal pulse to the skin. However, the redesigned ThermaClear acne device was smaller, handheld, and battery-operated, making it easier to use. Choi explained the purpose of the initial clinical trial: "It wasn't a trial to get FDA approval to go to market. We only wanted the 'TV effect'—before and after shots to show potential investors that the product accelerated the healing and clearing of acne pimples."

Choi introduced Scocimara to several dermatologists in the area, who helped the CEO design the clinical study that would require an institutional review board's (IRB) approval.¹ The research design was approved by an IRB in late May 2005, and the trial began several weeks later at a dermatologist's office in Palo Alto, California. Patients were adults and adolescents with mild to moderate inflammatory acne. Each patient underwent daily treatment over a total of five days, which consisted of: (1) cleansing the entire face; and (2) applying a single thermal pulse (100 degrees Celsius for two seconds) with the ThermaClear device to the treated area (the "lesion" or pimple). For each patient, lesions were randomly selected to receive treatment or no treatment over the course of the five days. The treated and untreated lesions were photographed daily. Two independent and "blind" observers (also dermatologists) reviewed and graded the photographed treated and untreated lesions based on their severity each day.

Results of the demonstration trial were expected in late July 2005. Assuming favorable results, the founders planned to expand into clinical trials that would be used to support the company's 510(k) filing² with the FDA to receive clearance to market the ThermaClear product over-the-counter as a Class II medical device.³ The company hoped to file the 510(k) in October 2005 and receive FDA approval in December 2005.

¹ The FDA and U.S. Department of Health and Human Services gave IRBs, which were committees based at research institutions, the power to approve, monitor, and review medical research that involved human subjects to ensure their safety.

² Under specific circumstances, device companies could submit a 510(k) filing to the FDA to receive clearance to market their devices. A 510(k) filing sped up the FDA approval process, and the FDA review of a 510(k) filing typically took 20 to 90 days. Often, the FDA responded to a company's 510(k) filing by requesting additional information or data that required a resubmission of the 510(k) filing. According to the FDA requirements for a 510(k) filing, a medical device had to be "substantially equivalent" to (i.e., as safe and effective as) an existing, legally U.S. marketed device, called a "predicate" device. ThermaClear's predicate device was a laser.

³ The FDA recognized three classes of medical devices based on the device's perceived risk to the user. ThermaClear was a Class II medical device, which meant it required "special controls" (such as labeling requirements or mandatory performance

The Zeno Zit Zapper

As the ThermaClear device was undergoing its demonstration trial, the DermaCare founders heard unexpected and unwelcome news. A competitive product—the Zeno Zit Zapper—was readying for launch. Zeno was an electronic acne-clearing device that was clinically proven to make treated pimples disappear more quickly than those left untreated. Houston-based medical device company Tyrell Inc. received FDA approval to begin OTC marketing of the Zeno Zit Zapper (also a Class II medical device) in June 2005. Similar to ThermaClear, Zeno was a handheld device that applied a controlled heat dose directly to a pimple. However, Zeno operated at a lower temperature (50 degrees Celsius) with a longer application time (150 seconds per pimple). The company planned to use a direct sales force to sell the device through medical offices and medically supervised spas and salons that sold the Zeno to end users for \$225. Scocimara recalled his reaction:

All of a sudden, it was, “Holy shaving cream! What are we going to do?” We had our dermatologist buy several Zenos, and we started using them. Their approach didn’t make any sense to me. Two and a half minutes per pimple. They were also selling it to dermatologists, but all our research said 80% of the people with acne didn’t go to a dermatologist. And most dermatologists we talked to said that acne wasn’t a moneymaker for them. Sure enough, Zeno’s model evolved quickly, and they expanded into spas. I kept saying, “Fine. Build the category. We have a totally different marketing strategy and lower cost and price points.”

Series A Fundraising

By the end of July 2005, favorable results from the demonstration trial were coming back, showing that ThermaClear cleared pimples twice as quickly as those left untreated. (See **Exhibit 2** for initial trial results.) Furthermore, early results from a comparison with Zeno showed the two products had similar efficacy. The ThermaClear device was in its third prototype phase, and the company was preparing to submit “requests for quotation” (RFQ) to device manufacturers in Asia. (See **Exhibit 3** for product illustration.) It was time to raise money, and the three founders decided to approach outside investors. Scocimara explained: “George, Luiz, and I weren’t taking a salary. We agreed that we were spending enough time and effort on the company and that adding more financial risk by funding the venture ourselves was too much.”

Scocimara put together a presentation to pitch to investors. Under the self-funding DRTV model, the CEO estimated that DermaCare needed to raise between \$1.0 and \$1.5 million to reach breakeven the second quarter of 2006. The money would be used to finish the clinical trials supporting the product’s 510(k) filing with the FDA. It would also fund the infomercial production and operating capital until mid-2006. Scocimara predicted the company would reach \$50 million in revenue in two years. (See **Exhibit 4** for the projected financials and **Exhibit 5** for company milestones.)

From the beginning, Choi counseled Scocimara to approach angel investors instead of venture capitalists. Angel capital was an important and growing source of financing for start-up companies. Angel investors were mostly high-net-worth individuals, and many angels were successful entrepreneurs themselves. Increasingly, angels were forming into groups or clubs that invested in and supported early-stage companies. (See **Exhibit 6** for a *New York Times* article on angel capital.) Choi described his reasons for preferring angel over venture capital for DermaCare:

standards) to ensure its safety and effectiveness. Other Class II devices included surgical lasers, X-ray machines, and powered wheelchairs. Class III, the most stringent regulatory category, included products such as heart valves and implantable pacemakers.

I was a VC recommending against VCs for several reasons. One, ThermaClear was a consumer product, which VCs weren't traditionally interested in. Two, VCs don't know much about DRTV, so they wouldn't add much value there. Three, we were looking for a very small amount of money—too small to be of interest to a VC. And four, how were the VCs going to exit this business? Companies usually don't go public under the DRTV model—they are cash cows and there's no need. I told Scotch not to waste his time with VCs.

Wally Buch

Choi put Scocimara in touch with Wally Buch, who coincidentally had introduced Choi to Da Silva several years earlier. Buch was a retired physician who had practiced cardiovascular and thoracic surgery for 25 years at Stanford University Hospital in Palo Alto and Sequoia Hospital in Redwood City, California. After he retired, Buch became a venture partner at MedVentures and joined the Band of Angels (the Band) in 1998, a group of angel investors in Silicon Valley. Choi explained, "When I sent Scotch down the angel path, I immediately thought of Wally. I usually bring Wally into my deals because he is smart and will tell me what I am doing wrong. And I thought the Band of Angels might be interested in investing, which would be more efficient than going to one angel investor at a time." Buch, Choi, and Scocimara sat down one afternoon in August 2005. Buch, who had three teenage daughters, was excited about the acne device and recalled, "Everybody's got pimples. I also had a lot of confidence that Luiz could produce a good product at a decent price. I told them I would put some money into it because I liked the idea and would bring it to the Band of Angels to see if others wanted to invest."

Ian Patrick Sobieski and the Band of Angels

Founded in 1994, the Band of Angels included approximately 125 high-net-worth investors who were dedicated to funding and advising seed-stage start-ups. The angels in the Band were largely current and former high-technology executives interested in investing in high-tech sectors such as Internet/web services, life science/biotech, semiconductor, networking/telecom, and software. Although Band members invested in ventures as individuals, the Band's principles and processes were designed to help the loose-knit group of angels evaluate, invest in, mentor, and monitor new ventures more efficiently and effectively. Ian Sobieski was the Band's managing director and coordinator. Sobieski had a PhD and MS in aeronautical engineering from Stanford University and was an early executive at the Internet start-up Evite.com prior to joining the Band in 1997. In 1999, Sobieski separately founded the Band of Angels Fund (the Fund), a \$50 million venture fund made up of institutional investors, not angels. He directed the Fund, which invested in many deals alongside the Band's angel investors. Sobieski described part of what he believed made the Band unique:

The background of our membership sets us apart from other angel groups. Many angel groups in the U.S. have "SEC qualified investor" criteria—an investor has to have a certain net-worth or level of investment activity. The Band has an additional membership criterion that requires a member to be either a founder, or a former exec of a high-tech company, or a high-level domain expert like Wally Buch. This excludes wealthy dentists and real estate developers from the Band, but we have the luxury of enforcing this additional standard because there are so many successful entrepreneurs and executives in the Valley. And it makes the Band a source of intellectual capital as well as financial capital.

The Band of Angels Fund also contributes to the Band's success by helping it be a more professional organization. It helps pay the bills involved in running the Band, provides extra capital to deals, and sometimes plays the "cold-handed fiduciary" in deal negotiation—a role

angels often dislike playing. Negotiating over price or other terms can stress the interpersonal relationship between entrepreneurs and angels and undermine the mentoring the angels hope to provide entrepreneurs later.

The Band's Investment Process

With Sobieski's approval, Buch submitted the DermaCare business plan to the Band of Angels "prescreen committee" for review. The prescreen committee had experts in every high-tech category and reviewed about 60 plans a month. The prescreen committee selected ten plans that would be presented to a different standing committee—the "deal-screening committee"—consisting of eight Band members (at least one from each of the high-tech sectors). Each deal-screening committee member rank-ordered the ten plans, and the top three companies were invited to present to the full Band of Angels at the monthly Band dinner, typically attended by 40 to 60 Band members. A company had 15 minutes to present, followed by a five-minute question-and-answer period. Dinner attendees signed sheets saying whether they were interested in following up on a particular deal. If enough members expressed interest, a luncheon was held to allow prospective investors to ask more detailed questions and to get more familiar with the management team and investment terms. A Band member's participation in a deal typically ranged from \$25,000 to \$100,000. On average, one company received an offer of funding per month from the Band, ranging from \$300,000 to \$750,000 per company, at the end of the screening process. Since 1994, the Band had funded more than 220 companies with 50 profitable exits, including nine NASDAQ initial public offerings. As Sobieski commented, "Our 53% IRR makes the Band by far the most successful angel group in the country."

Under Buch's sponsorship and guidance, the DermaCare plan sailed through the Band's screening process. Scocimara presented at the monthly dinner on September 14, 2005, and attended a follow-up luncheon a week later. Within a few days, Buch called the CEO with the Band's "expression of interest." Scocimara said:

Wally thought the rough number was \$750,000—between \$250,000 and \$350,000 from the individual Band members and about \$500,000 from the Band of Angels Fund that Ian ran. So the good news was that they were interested; the bad news was it wasn't enough. Buch also advised me to move quickly; the whole process was like herding cats. Some angels come in, and some drop out. It can be a bit of a moving target.

As the interested Band members reviewed DermaCare's due-diligence package, Scocimara and Choi approached other potential investors, including Sand Hill Angels, another local angel group. Scocimara presented to the Sand Hill members at their monthly meeting, but the membership passed on investing. The pair continued to pitch their plan. Several weeks later, they met with David Arscott of Compass Technology Partners, a smaller, local VC firm specializing in life science and communication and information technologies. Scocimara recalled:

One of the partners had DRTV experience, and they were interested in investing between \$500,000 and \$750,000. We also had a bunch of small piggyback parties totaling another \$300,000 or so who said, "Once you have a deal, we're in." By the first week of November, we had potential commitments of close to \$2 million. We put Compass and Band of Angels together so we could hammer out a term sheet.

Charles Moldow and Foundation Capital

As Scocimara developed DermaCare's business plan, he sought the advice of his longtime friend and former roommate Charles Moldow, whom he had met at Harvard Business School (HBS). After HBS, Moldow had been a member of the founding teams of @Home Networks (a former Internet

service provider) and, more recently, Tellme Networks (a provider of telephone-based applications such as voice-enabled mobile search), before becoming a venture capitalist with Menlo Park-based Foundation Capital in 2005. Foundation Capital provided early-stage funding to companies primarily in the Internet infrastructure, telecommunications/networking, enterprise software, and on-demand software businesses. Moldow discussed his early conversations with Scocimara about DermaCare:

I had helped Scotch get his job at LiveOps where I had been on the board. I was a bit surprised when he left LiveOps, but I knew he had become passionate about this acne device. I thought if his company had a different approach to treating acne, it could be interesting. The acne market is huge, with price-insensitive consumers who are desperately seeking solutions. I talked with him a lot about the project—as a friend, not as a potential investor. I didn't think my partners would consider the device, because it was not in our scope: It was a device; it was hardware; and it was in medical. It's also not a classic venture-capital medical device. Frankly, I thought it would be hard for Scotch to raise money. Angel investors seemed like the best fit because they could get excited about the device and not hung up with concerns like "What is the venture's exit strategy"?

However, in late October 2005, Moldow invited Scocimara to present DermaCare's business plan to his partnership. Moldow described the rationale behind his invitation and his partners' reaction:

I was the new guy in the partnership. I thought that DermaCare's model was so different, I could get a calibration of the partnership—how it would think about something like this. Would the partnership be open to direct consumer ideas or different business models? I also thought it would be good for Scotch to hear their feedback. After Scotch presented and left the room, they all said, "Wow, that was great." I was just shocked—really shocked. The other partners liked how it leveraged my skill set with LiveOps, and they wanted to get more into the consumer space. But, and this was a *big* "but," they wanted a "medical guy" who had medical device and FDA experience to invest alongside with us.

Moldow continued:

I thought: "Good feedback, but I don't care enough about this venture to dig up that right medical person." Plus, I was a bit reluctant to get involved as an investor in a good friend's business. However, the company seemed a good fit with a thesis I was developing about consumer-driven home health care. I believed that improvements in technology were driving medical devices and procedures, which were originally delivered in hospitals—then surgery centers, then doctors' offices—into people's homes. As a firm, if we could build a competency around bringing these devices into consumers' homes, we'd have every entrepreneur with one of these ideas hunting us down and asking for funding.

A couple of days after Scotch made his pitch, my wife and I were having dinner with Mark Foley and his wife. I didn't know him that well, but I remembered he was a partner at RWI Ventures [a Menlo Park-based VC firm that had invested in several life science early-stage companies] and had run a medical device company. He also knew George. I asked his take on the DermaCare venture, and he said, "I'd love to do a deal like that." All of a sudden, we had a consortium, and we both brought something to the table. Mark was relying on my knowledge of the DRTV industry and Scotch; I got the "medical guy" with FDA and medical device experience.

Moldow and Foley began crafting a term sheet. They knew that Scocimara was negotiating a term sheet with another group, although they didn't know the terms and that it was with the Band of Angels.

Competing Term Sheets

In mid-November 2005, the Band of Angels sent Scocimara its term sheet. At the end of the following week, Scocimara and Choi met Moldow and Foley at the Foundation Capital offices to review the VCs' proposed deal. (See **Exhibit 7** for term sheets.) After the meeting, Scocimara and Choi drove to a neighborhood café in Palo Alto to debrief. Scocimara described their discussion:

We talked about striking the right balance between fear and greed. On the greed side, we wanted to maintain as much ownership of the company as we possibly could until we could realize value. On the fear side, we wanted to raise sufficient capital to get us to the next major milestone with an increase in valuation or to the point where we didn't need to raise any more money from "high-cost sources." Clearly, the VC money was a much safer alternative; it provided us with more capital *and* with follow-on capital. Moreover, we had just missed our target date for filing with the FDA, so we knew that everything might not go according to plan. But there was a lot more dilution involved. The angel money was riskier but came with less dilution.

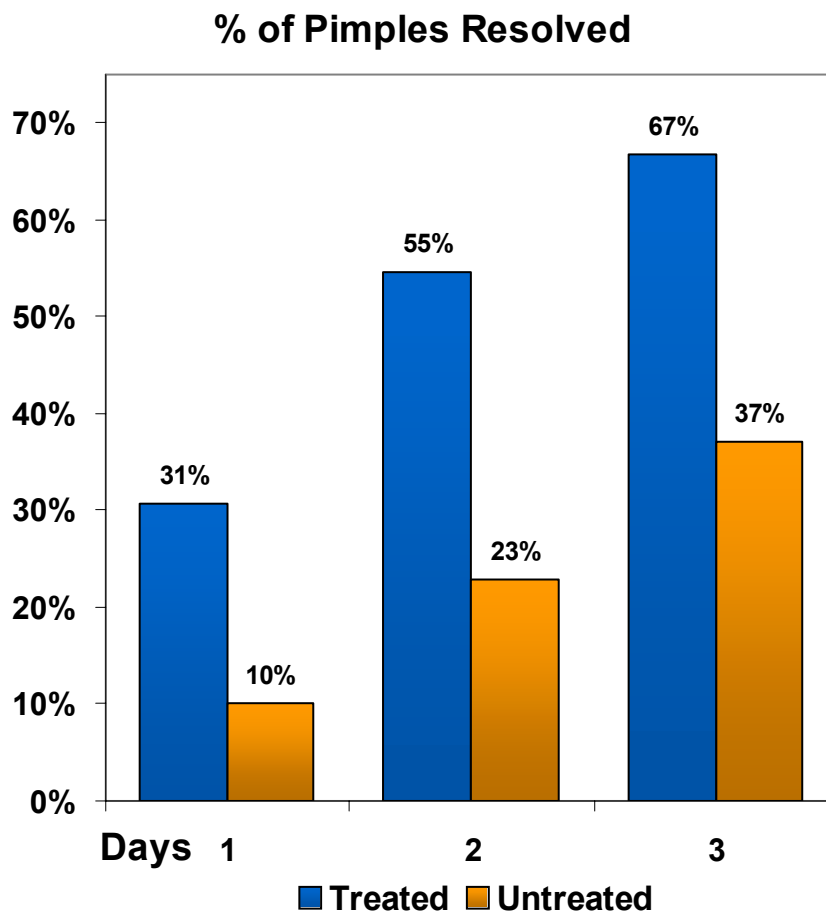
We also discussed the expectations that came with the money. Venture capital tends to mean much bigger plays. They are looking for a \$500 million play—a swing for the fences—the exit is either to be acquired or to go public. The angels might be more flexible and happy with a cash-flow business that pays out large dividends.

A third element for me was my friendship with Charles. Did I want to take money from one of my best friends? Charles was in my wedding. How would it be to have him on my board? And moreover, Charles was a relatively new venture capitalist. George and I agreed to think about the proposed deals over the weekend and scheduled a meeting with Luiz on Monday morning to decide which deal to take.

Exhibit 1 DermaCare Initial Capitalization

Investor	Investment (\$)
George Choi	\$110,000
Luiz Da Silva	10,000
Peter Scocimara	103,750
Other (3 investors)	51,875
Grandstock Corporation (Russian scientists)	For services
Total	\$275,625

Source: Company data.

Exhibit 2a Initial Clinical Trial Results for ThermoClear Acne-Treatment Device

Source: Company data.

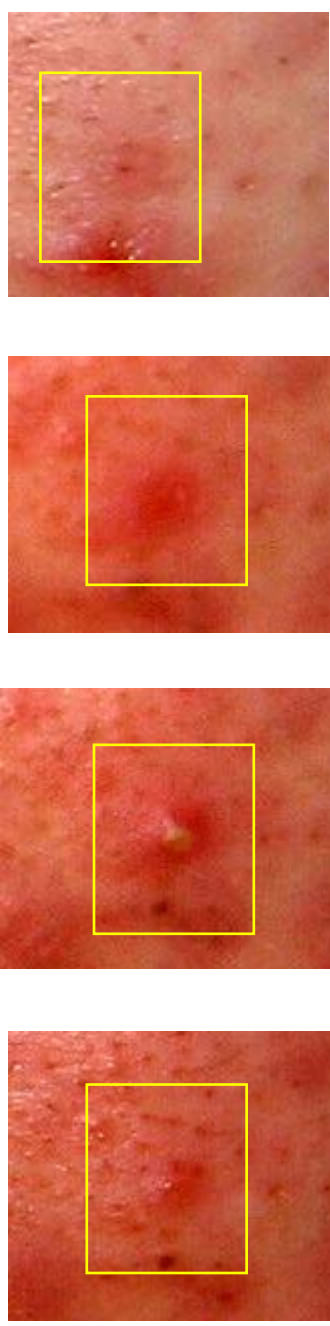
Note: "Treated" refers to lesions (pimples) treated with the ThermoClear acne-treatment device.

Exhibit 2b Initial Trial Results for ThermoClear Acne-Treatment Device

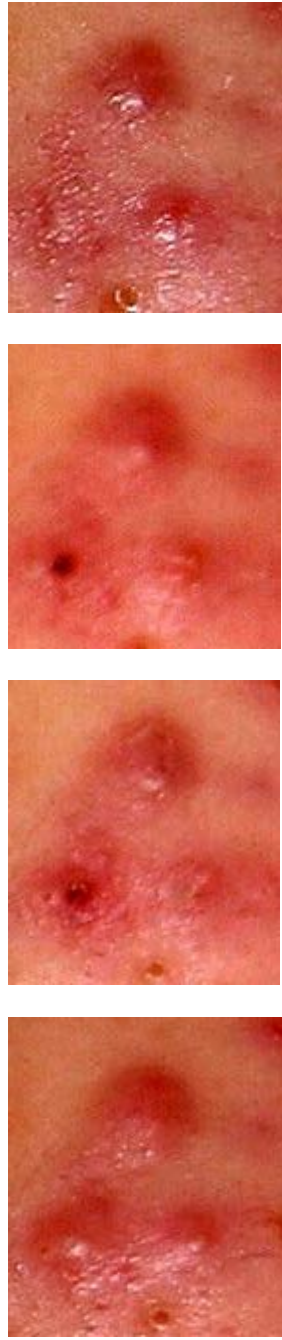
Same Face
Same Photo



Treated



Untreated



DAY 4

DAY 3

DAY 2

DAY 1

Source: Company data.

Exhibit 3 ThermaClear Acne-Treatment Device



Source: Company data.

Exhibit 4 DermaCare Projected Financials as of Mid-September 2005 (\$ million, except for volume)

	2005	2006	2007
Volume (thousands)	--	375	884
Revenue	\$ --	\$25.4	\$52.1
Cost of sales	--	9.6	22.2
Marketing and sales	0.1	7.4	11.6
G & A	0.4	1.5	1.6
Startup/development	0.2	0.3	0.2
Operating profit	-\$0.7	\$6.7	\$16.5
Profit after tax	-0.7	4.3	9.9
Cash	\$0.6	\$5.0	\$14.8
Key Metrics:			
Monthly burn rate (pre-launch)	\$120,000		
Breakeven units per month	5,000		
Breakeven month	April 2006		

Source: Company data.

Note: In mid-2005, Scocimara increased his assumption on the ThermaClear's suggested retail price because of higher-than-expected projected manufacturing costs. The financials assumed a \$69.95 suggested retail price.

Exhibit 5 DermaCare Company Milestones as of Mid-September 2005

Date	Milestones
November 2004	Company founded and incorporated with \$20,000
April 2005	Company raised \$275,000 from founders and new CEO
June 2005	Demonstration trial begins
September 2005	TUV (electronic safety) review
September 2005	Requests for quotes from device manufacturers in Asia
October 2005	FDA filing expected
December 2005	FDA approval of company's 510(k) expected
January 2006	Expected date for commencement of marketing
April 2006	Expected breakeven month

Source: Company data.

Exhibit 6 *New York Times* Article “Financial Angels Band Together”

By JAMES FLANIGAN

Two weeks ago, 40 successful businesspeople sat around a horseshoe table in a university lecture hall firing questions at four aspiring entrepreneurs. The aspirants were giving 20-minute presentations about their start-up companies to the Los Angeles chapter of Tech Coast Angels, a group that invests in new businesses.

Last Monday, in a hotel ballroom in Anaheim, a dozen eager entrepreneurs took part in an even more intense screening called the Fast Pitch competition of the Orange County chapter of Tech Coast Angels. In Fast Pitch, competitors have 60 seconds to give an account of their business and their plans in hopes of impressing venture capital funds, which typically put up bigger money than the Angels do.

Early in a company’s financial life, after friends and family have been tapped for initial stakes, comes angel capital—investments from individuals, often successful entrepreneurs themselves, who back newcomers starting out as they once did on a smile and a shoeshine.

Their numbers and importance are growing. Last year Angels, along with some venture capital backers of start-ups, invested \$4.2 billion in more than 1,000 early-stage companies, according to Luis Villalobos, founder of Tech Coast Angels in Orange County. It is one of some 200 angel capital groups in the United States.

The movement was inspired by Band of Angels, the first formal angel group of a dozen Silicon Valley entrepreneurs gathered by Hans Severiens, a nuclear physicist and investor, to listen to aspiring entrepreneurs and possibly take a flier on their dreams. The Band, which first met in 1994, has backed household names like Cisco Systems. It now has more than 100 members and still meets once a month to examine prospects.

It was advice from Mr. Severiens, who died in 2004, that encouraged Mr. Villalobos, a two-time successful entrepreneur and engineer, to persevere in forming Tech Coast Angels in 1997. At that time, he recalled, local business colleagues told him: “‘You’re crazy. There are no venture investors or technology or entrepreneurs in Orange County, other than maybe in real estate.’”

Yet in 10 years, Tech Coast Angels has grown to 270 members in four locales—Orange County, Los Angeles, San Diego and Westlake/Santa Barbara—who have invested collectively \$85 million in 128 companies.

It’s a sign of how attitudes toward risk have changed in little more than a decade that seasoned executives and financial managers now readily join groups to put \$200,000 to \$1 million behind people with ideas and a sense of adventure. Top corporate executives with outsize pay and perks may have been heroes of American business in bygone decades, but these days the entrepreneur is king or queen and praised for creating jobs and innovation in the American economy.

It helps that returns on angel investing have been quite attractive. “Angel investors typically earn 5 to 10 times their money in four to eight years,” said Mr. Villalobos, citing a PricewaterhouseCoopers Money Tree study of venture capital. But the spread of angel investing attests also to the economy’s encouragement of innovation, whether in high technology or everyday products.

For example, Richard Morganstern, a patent lawyer who is president of Los Angeles Tech Coast Angels, recalled the group’s introduction to Language Weaver, a company that created a software product for automatic translation at the University of Southern California, with the aid of grants from the Defense Department. The Defense Advanced Research Projects Agency asked the group in 2000 to help Language Weaver become a commercial enterprise, Mr. Morganstern said.

“So we mentored the inventors and brought in executive talent,” he said. “And then in 2002, after 9/11 increased demand for Middle Eastern languages, we invested along with other venture groups.”

Today, Language Weaver, much in use in Iraq, is adding corporate customers interested in translations to Chinese and 16 other languages.

In April, the Orange County Tech Coast Angels invested \$900,000 in YouMail, a company that adapts telephone greetings so that a group of selected callers receives a personalized message. The firm's original idea was that the service would appeal to sales agents and brokers eager to greet clients in a personal way, but Alex Quilici, YouMail's chief executive, said that his customers tended to be younger. "Generation Y that likes to personalize everything is spreading the use of our product," he said.

Angel capital groups, whose members invest their own money, pride themselves on rolling up their sleeves to help fledgling concerns. With each group member obliged to review four to eight companies a month and invest \$50,000 a year in some of them, Angels say they act like a "farm system" doing the due diligence on small companies that traditional venture capital funds no longer take time for.

One Angel network, the Keiretsu Forum, founded seven years ago in Lafayette, Calif., east of San Francisco, has grown to 500 members in Colorado, Idaho and Washington as well as California. Keiretsu's size allows it to make larger investments, said Randy Williams, who started the group. (The name derives from the Japanese word for companies linked by cross-ownership of shares.)

Two years ago, for example, Keiretsu investors backed Earth Class Mail with \$1.75 million. The firm is a licensed mail receiver that can collect clients' mail, show it to them on e-mail and then, with customer approval, open the mail, scan it and show the contents on the e-mail screen. Employees traveling the world for multinational companies are customers, said the founder, Ron Wiener, "and also today's decentralized employees who work on their own and check in for conferences to rented office suites."

For all today's enthusiasm for entrepreneurs, angel capital is not easily handed out. Gerrie Adams, co-founder of Xengaru Fun Foods of Laguna Niguel, in Orange County, tells of competing in the Tech Coast Angels Fast Pitch Competition to get expansion capital. Ms. Adams and her business partner, Anuradha Prakash, had gained Angel backing and even National Aeronautics and Space Administration recognition for the low-cholesterol and fat content of their Pizzettos pizza chips.

But in 2005, Xengaru needed more money to expand nationally. Ms. Adams recalled facing 300 professional investors. "I was terrified," she said. "I had 59 seconds to get my point across." So Ms. Adams, a former sales and marketing manager, opened her pitch with alarming statistics about childhood obesity, noted that state governments were already banning unhealthy snacks, and then related quickly that schools loved Xengaru's low-fat pizza chips because they were healthy and children loved them because they taste good. She won the right to a potential \$500,000 in expansion money for Xengaru.

The next stage for angel capital? Not surprisingly, it's globalization. Keiretsu Forum opened a chapter in Beijing last year "and we will open next in Shanghai," Mr. Williams said. There appears to be a receptive audience for entrepreneurship in China.

Kevin Scanlon, a member of the Los Angeles Tech Coast Angels, returned recently from China, where government officials and businesspeople "were eager to learn how angel capital works and how we put our groups together," Mr. Scanlon said. "The angel capital idea could be our next great export."

Source: James Flanigan, "Financial Angels Band Together," *New York Times*, May 17, 2007.

Exhibit 7a Band of Angels Term Sheet

Company: DermaCare, Inc. (the “Company”)
Lead Investor: Band of Angels, LLC
Capitalization: The following sets forth the capitalization of the Company on a pro forma basis after raising approximately \$1,500,000 and giving effect to the issuance of shares of Series A Preferred Stock by the Company.

	No. of Shares	% Outstanding
Common Stock	4,000,000	60.6%
Options	400,000	6.1%
Series A	<u>2,205,883</u>	<u>33.3%</u>
Total	6,605,883	100.0%

The following sets forth the terms of the Company’s proposed Series A Preferred Stock financing.

Security: Series A Preferred Stock
Amount: The total amount to be raised in this round of financing will be \$1,500,000.
Number of Shares: 2,205,883 shares of Series A Preferred Stock
Purchase Price: \$0.68 per share
Closing Date: The financing will close on or before November 30, 2005.

TERMS OF SERIES A PREFERRED STOCK

Dividends: The holders of Series A Preferred Stock will be entitled to receive a non-cumulative dividend in preference to any dividend on Common Stock when, as, and if declared by the Company’s board of directors.

Liquidation Preference In the event of any liquidation or winding up of the Company, each holder of outstanding shares of Series A Preferred Stock will be entitled to receive their original purchase price per share, plus all declared but unpaid dividends, of such shares prior to distributions made to holders of Common Stock or any other junior equity security (the “Preferential Amount”). After payment of the Preferential Amount to the holders of Preferred Stock, the holders of Common Stock will be entitled to receive the remaining assets or property of the Company.

Conversion: The holders of Series A Preferred Stock shall have the right to convert the Series A Preferred Stock, at the option of the holder, at any time into Common Stock of the Company.

Conversion Price: The initial conversion price of the Series A Preferred Stock will be \$.68.

Automatic Conversion: The Series A Preferred Stock will be automatically converted into Common Stock, at the then applicable rate, upon (i) the closing of a firm commitment underwritten public offering of shares of the Company’s Common Stock at a price per share not less than \$3.00 per share (as may be adjusted to reflect

subsequent stock dividends, stock splits or recapitalizations) and for a total gross offering proceeds of not less than \$10,000,000 ("Qualified Public Offering") or (ii) approval of the holders of at least 66-2/3% of the Company's Preferred Stock.

Conversion Price
Adjustments:

The conversion price of Series A Preferred Stock will be subject to adjustment to prevent dilution, on a weighted average basis, in the event that the Company issues additional shares of Common Stock, convertible securities or warrants or grants stock options or issued other Common Stock equivalents (other than shares reserved for issuance to officers, employees, directors, consultants or advisors of the Company pursuant to stock option or restricted stock purchase plans or agreements, net of repurchases (the "Employee Pool"), and other than securities issued in connection with research and development partnerships, licensing or collaborative arrangements and similar transactions approved by the Company's board of directors) at a purchase price less than the applicable conversion price. In the event of any stock splits, stock dividends or combinations, proportionate adjustment will be made to the conversion price of the Series A Preferred Stock.

Voting Rights:

Each share of Series A Preferred Stock will carry one vote per share of Common Stock then issuable upon its conversion. The Preferred Stock will vote together with the Common Stock and not as a separate class, except as specifically provided herein or as otherwise required by law.

Protective Provisions:

Consent of the holders of at least a majority of the Preferred Stock shall be required for any action which (i) results in the sale of all or substantially all of the Company's assets, property or business, (ii) adversely alters or changes the rights, preferences, privileges or restrictions of the Preferred Stock, (iii) creates (by reclassification or otherwise) any new class or series of shares having rights, preferences, or privileges senior to or on parity with the Preferred Stock with respect to voting, dividends or redemptions or upon liquidation, or (iv) increases the authorized number of shares of Preferred Stock, (v) any change in the size or composition of the board of directors., or (vi) increases the size of the option pool.

Protective Employee
Agreements:

Company executives and key employees will enter into a proprietary information agreement, a patent assignment agreement and an employment agreement with standard vesting. The company shall not accrue salaries or liabilities not explicitly approved by the investors prior to closing.

Exceptions:

The company shall provide investors with a schedule of material exceptions as soon as possible after the signing of this term sheet.

Right of First Offer:

Prior to a Qualifying Public Offering, each investor holding Series A Preferred Stock will have a right of first offer to purchase its respective pro rata share of new securities offered by the Company, other than securities issued to certain officers, directors, employees, consultants and advisors of the Company pursuant to stock option or restricted stock purchase plans or agreements included in the Employee Pool and other than securities issued in connection with research and development partnerships, licensing or collaborative arrangements and similar transactions approved by the Company's board of directors. In the event that any holder elects not to purchase such pro rata shares, such shares shall be offered to other holders of Series A Preferred on a pro rata basis.

Purchase Agreement: The investment shall be made pursuant to a Stock Purchase Agreement reasonably acceptable to the Company and the investors, which agreement shall contain, among other things, appropriate representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein and appropriate conditions of closing including an opinion of counsel for the Company.

OTHER MATTERS

Fees: The Company and the investors shall each indemnify the other for any finders' fees for which they may be responsible. The Company shall reimburse the legal fees and expenses associated with the transaction contemplated by this Term Sheet incurred by the Lead Investor up to a maximum of \$10,000.

CEO Salary: The initial CEO salary shall be a maximum of \$225,000 per annum. The disinterested members of the Company's board of directors, on an as needed basis, shall determine any future revisions to the CEO's annual salary.

Board of Directors: Upon the closing of the financing contemplated by this Term Sheet, the Company's board of directors shall consist of two representatives of the Series A Preferred Stock, two representatives of Common Stock, and one individual selected by the majority of the four representatives. Initially, the two representatives of Series A Preferred Stock shall be Dr. Wally Buch (the "Series A Preferred Stock Representative") and [], the two representatives of Common Stock shall be George Choi and Peter Scocimara, and the one individual selected by the majority of the four representatives shall be [].

Board of No Shop: The Company agrees not to engage in discussions with investors not approved by the Lead Investor, for a period of 30 days from the signing of this term sheet, or to entertain other offers for the financing of the company during that period.

The undersigned hereby acknowledge that the sections entitled No Shop and Fees ARE BINDING ON ALL PARTIES. All other sections are non-binding and for discussion purposes only.

Source: Company documents.

Exhibit 7b Foundation Capital Term Sheet

<u>Size of Financing:</u>	Total size: \$4.15 million with \$3 million from Foundation Capital, \$1 million from RWI Group and \$150,000 from individual investors at the founders choosing. The first closing shall be for \$1 million, invested ratably by Foundation Capital, RWI Group and the individual investors (the Investors). The second closing shall happen at any time thereafter at the option of the Investors or at any time at the option of the Company following FDA 510K approval.
<u>Type of Security:</u>	Series A Preferred stock
<u>Valuation:</u>	\$7.65 million post-financing. This valuation is to include an available option pool of 15% of the post-funding capitalization, which is intended to be sufficient for the Company's needs over the next 18 months.
<u>Board of Directors:</u>	Board Size: Five. Two representatives of the common shareholders, one of whom shall at all times be the CEO. Three representatives of the preferred shareholders including two from Foundation Capital and one from RWI Group. After the first year following the financing, one representative from Foundation Capital will be replaced with an outside industry expert subject to approval by class votes of both the common and preferred shareholders. [This will bring the Board composition to two investor representatives, one outside representative, and two common shareholder representatives.]
<u>Other Terms:</u>	<ul style="list-style-type: none"> • Series A shall represent a simple Preferred security with no participation rights. • Broad-based weighted average anti-dilution protection. • Approval for fundamental changes or merger/acquisition via a majority vote of the Preferred Shareholders • Registration rights • Right to maintain ownership percent in future financings • Last refusal and co-sale rights with respect to shareholder's stock • Redemption rights beginning 5 years from the date of this financing and allocated 1/3 each year for three years • IPO participation rights equal to 10% of the shares in the offering. • Key man life insurance • Company to pay investor counsel expenses up to \$35,000 • Employee stock to be subject to standard 4 year (one year cliff) vesting beginning with start date. Employee vesting for options already issued and subject to the current employee option plan shall not change (i.e. 4 years from original start date). Peter Scocimara restricted stock will vest according to the existing restricted stock agreement in place with the company. • No acceleration of employee vesting except with Board approval. Peter Scocimara restricted stock contains a double trigger. • The closing is dependent upon all trial data that has not yet been assembled being consistent with trial data already provided to Foundation • George Choi and Luiz Da Silva are to assign all IP rights over to DermaCare • Final agreement to include other customary terms, reps and warranties
<u>Timing:</u>	Financing to close as soon as possible with a 30 day "no shop" agreement in the interim.

This Investment Proposal is subject to completion of due diligence and mutually acceptable of definitive financing documents. This Investment Proposal expires at midnight 5 business days from the date hereof unless executed by both parties prior to that date and is not intended as a binding contract in and of itself.

Source: Company documents.